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Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Attention: Ms. Jennifer J. Johnson
Secretary

Re: Federal Reserve Regulation CC; Docket No. R-1176

Governors:

The New York Clearing House Association L.L.C. (The Clearing House")¹ and its affiliates Electronic Clearing Services L.L.C., Electronic Payments Network L.L.C., The National Check Exchange Company L.L.C., and The Small Value Payments Company L.L.C. are pleased to respond to your request for comments on the proposed amendments to Regulation CC that would implement the Check Clearing for the 21st Century Act ("Check 21") and clarify some existing provisions of Regulation CC and its commentary.

Set forth below is a brief summary of issues on which the Board has requested comment followed by our responses. Page references are to the Board's request for comments. Also set forth at the end of the letter are (i) a description of an additional change that we would like the Board to make to Regulation CC that would help reduce the occurrences of identity theft and (ii) a description of a problem that has come to our attention related to original checks with information on the face of the check that is not image survivable.

1. The Board requests comment on the proposed commentary to the substitute check definition that describes the various ways in which the MICR line of a substitute check may vary from the MICR line of the original check (pp 61-64). In summary, only the amount field and position 44 may vary. In addition, the reconverting bank would be required to repair MICR-line errors in order to create a substitute check that is the legal equivalent of the original check.

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The member banks of The Clearing House are Bank of America, National Association; The Bank of New York; Bank One, National Association; Citibank, N.A.; Deutsche Bank Trust Company Americas; Fleet National Bank; HSBC Bank USA; JPMorgan Chase Bank; LaSalle Bank National Association, U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

Comment: The Board's proposed commentary to the substitute check definition that describes the various ways in which the MICR line of a substitute check may vary from the MICR line of the original check would cause significant problems and uncertainty for banks and their customers.

On the one hand, proposed § 229.2(zz) provides that there are only two ways that a substitute check's MICR line may vary from the original check's MICR line: (i) a reconverting bank may repair only an encoding error that appeared in the amount field of the original MICR line and (ii) the numeral in position 44 may vary to identify the check as a substitute check ("4" in position 44) or a qualified return substitute check ("5" in position 44 on the qualified return strip). On the other hand, proposed § 229.2(zz) effectively requires a reconverting bank to repair every MICR-read error in any field when it creates a substitute check. This is confusing and seemingly contradictory.

For the reasons discussed below, we believe that these restrictions are unnecessary and would create considerable operational/processing difficulties for banks and uncertainty for banks and their customers. We believe that the MICR line on a substitute check should be allowed to vary in any way from the MICR line on the original check without affecting a substitute check's status as the legal equivalent of the original check. We believe this approach would be much less confusing to banks and their customers.

Repair of MICR-line

We believe that a reconverting bank should be able to repair any field on a substitute check's MICR line without negating the status of the check as the legal equivalent of the original check.

We believe that the approach taken by the Board in the commentary to proposed § 229.2(zz) to allow only the amount field on the MICR line of a substitute check to vary from the MICR line on the original check is based on an invalid premise, i.e., that it is the generally applicable industry practice for a bank to repair only the amount field on a MICR line. It is also an industry practice followed by banks in clearing house arrangements to permit or require a collecting bank to repair both the amount field and the routing number field and for a collecting bank to correct any other field if the paying bank agrees that it may do so.

Enabling a reconverting bank to repair any field on a check's MICR line would facilitate automated processing of the check from the reconverting bank to the drawer's account at the paying bank. Restricting repair to the amount field not only would impede automated processing but would cause uncertainty among banks that subsequently handle the check. For example, paying banks might want reconverting banks to repair erroneous routing numbers in order to facilitate the automated processing of a substitute check to the correct paying bank but a

reconverting bank would be constrained from doing so because it would be creating a substitute check that is not the legal equivalent of the original check. As a result, paying banks would receive more checks that contain their routing numbers in error. In addition, a paying bank would be uncertain about its authority to debit a customer's account for a substitute check because it might not be the legal equivalent of the original due to improper MICR repair.

As discussed further below, we believe the encoding warranty provisions in § 4-209 of the U.C.C. (1990 Official Text) and § 229.34(c)(3) of Regulation CC should apply to the repair of a substitute check's MICR line by a reconverting bank, collecting bank, or paying bank just as they apply to the repair of an original check's MICR line.

Position 44

We agree with the approach taken by the Board in the commentary to proposed § 229.2 (zz) that a reconverting bank may vary the information in position 44 of a substitute check without negating the check's status as a legal equivalent. However, we do not agree that the examples to the commentary should specify the exact numerals that may appear in position 44. Banks may develop other numerals besides the ones specified in the proposed example to designate that a check is both a substitute and something else, e.g., a substitute check that is also a third-party draft. They should be given the flexibility to do so as participants in working groups under the Accredited Standards Committee X.9, Inc. ("ASC X 9").

The Board's proposed regulations do not require a reconverting bank to place a numeral in position 44 of a forward collection substitute check to identify it as a substitute check. The purpose of the identifying numeral is to prevent a substitute check from being further reduced in size when it is converted back into electronic form and reconverted again into a substitute check one or more additional times.

We are concerned that if a subsequent reconverting bank inadvertently further reduces a substitute check in size because no identifying numeral appears in position 44, a subsequent reconverting bank would be liable for consequential damages under § 229.53(b) because it breached its warranty under § 229.52(a)(1) that the substitute check accurately represents all of the information on the original check (if the information on the subject check is illegible due to its further reduction in size). In such a situation, the subsequent reconverting bank would not be able to recover the consequential damages from the original or other earlier reconverting bank because that bank did not breach the § 229.52 (a)(1) warranty (if the information on the larger substitute check that the earlier reconverting bank created is still legible).

As discussed below in our Recommendation, we believe that a reconverting bank's failure to put the correct identifying numeral in position 44 during its creation of a substitute check should be treated as a violation of the Check 21 Act and § 229.2(zz) of the proposed regulations. In addition, for the reasons stated in our Recommendation, we believe that the Board

should amend the commentary to the proposed regulations and Regulation CC to provide that a reconverting bank's failure to put the correct identifying numeral in position 44 would constitute a breach of the encoding warranties in U.C.C. § 4-209(c)(1990 Official Text) and Regulation CC § 229.34(c).

Correction of MICR-read errors

We also believe that a collecting bank's correction or failure to correct a MICR-read error should not affect a substitute check's status as the legal equivalent of the original check.

Under the Board's commentary to proposed § 229.2(zz), if a collecting bank does not correct a MICR-read error anywhere in a check's MICR line, it would not create a substitute check that is the legal equivalent of the original check. A MICR-read error is caused by a defect in the readability (by a bank's automated check sorter) of a character in a check's MICR line. For example, if the magnetic ink on part of the numeral 8 in the MICR line is weak or flaking, the numeral may be read as a 3 when it is converted from the original check to an electronic image. If the magnetic ink is weak it may also be completely unreadable and an asterisk will appear in its place when the original check is converted to an electronic image. The commentary to proposed § 229.2(zz) would require a reconverting bank in such a situation to change the 3 or asterisk back into an 8. If it does not, it would not create a substitute check that is the legal equivalent of the original check.

We believe that a great deal of confusion would result on the part of customers and banks if a check's status as a substitute check that is the legal equivalent of the substitute check were to hinge on a reconverting bank's correction of a 3 or an asterisk on an electronic image to an 8 on the substitute check as described in the above examples.

Recommendation

We believe that the better approach would be for the regulations to clarify that a check is still considered a substitute check with legal equivalence, even if the substitute check's MICR line is not an exact match of the original check's MICR line.

A reconverting bank's failure to properly apply the MICR line during its creation of a substitute check, including its failure to correct MICR-read errors and to insert the correct identifying numeral in position 44, should not be treated as a breach of the legal equivalence warranty in proposed § 229.52(a)(1). Instead, it should be treated as a violation of the Check 21 Act and § 229.2(zz) of the proposed regulations, which require that a substitute check, *inter alia*, (i) bear a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks and (ii) is suitable for automated processing in the same manner as the original checks. In addition, a reconverting bank's misapplication of the

MICR line during its creation of the substitute check would be a breach of the encoding warranties in U.C.C. Article 4-209 (1990 Official Text) and § 229.34(c)(3) of Regulation CC.

After a substitute check has been created, we believe that the repair of the check's MICR line by a reconverting bank, collecting bank, or paying bank should be a breach of the U.C.C. and Regulation CC warranties. This should include the omission of the correct identifying numeral in position 44 by a downstream bank performing full field repair with a MICR strip. It should not be considered a violation of the Check 21 Act and its regulations nor should it be considered a breach of the warranties in proposed § 229.52.

We believe the approach described above would protect banks that subsequently handle substitute checks and their customers from losses resulting from receiving a check with bad or incorrect MICR information without negating the substitute check's status as the legal equivalent of the original check. However, in order to ensure that all losses arising from a reconverting bank's erroneous application of the MICR line during its creation of a substitute check are properly allocated, we recommend that the Board make two changes to the proposed regulations. First, we recommend that the Board revise the commentary to § 229.2(zz) to clarify that a reconverting bank would be liable under the encoding warranty in U.C.C. § 4-209(c)(1990 Official Text) for all damages incurred by a collecting or paying bank as a result of the reconverting bank's misapplication of the MICR line during its creation of a substitute check, including its failure to correct MICR-read errors and to insert the correct identifying numeral in position 44. This would include a paying bank's liability for consequential damages to a customer for wrongful dishonor under U.C.C. § 4-402 (1990 Official Text). Second, since New York and South Carolina have not adopted U.C.C. § 4-209 (1990 Official Text), we also strongly recommend that the Board modify Regulation CC § 229.34 (c) and the commentary thereto to provide that a reconverting bank has the same liability under § 229.34(c) that it has under U.C.C. § 4-209 (c) for its misapplication of the MICR line during the creation of a substitute check. This is necessary to insure that all reconverting banks have the same liability for these errors. Please note that the state U.C.C. provisions usually provide for a three-year statute of limitations while the Reg CC statute of limitations is one year. Therefore, we recommend that the modification to Regulation CC that we proposed above provide that if the applicable state U.C.C. has a three-year statute of limitations, then that longer statute of limitations will apply.

To reiterate our position regarding legal equivalence and MICR line variations, we strongly urge the Board to clarify that any variance between the MICR lines of an original check and the corresponding substitute check (whether caused during the application of the MICR line by the reconverting bank when creating the substitute check or during the subsequent repair of the substitute check's MICR line by a reconverting, collecting, or paying bank) does not negate the status of the check as a substitute check that is the legal equivalent of the original check, but instead is a failure to comply with the Act and Regulations or a breach of an encoding warranty. The risk of these items being rejected and not paid, or being paid, but not considered the legal equivalent, outweighs the risks of receiving a check with bad or incorrect MICR.

MICR Line Information Not Encoded in Magnetic Ink

We also believe that a substitute check should not lose its status as the legal equivalent of the original check if the MICR information on the check is not encoded in magnetic ink in the limited situation where the following conditions exist: (i) the reconverting bank is the paying bank, (ii) the paying bank has created the substitute check solely to return it to its customer (iii) the information from the original check's MICR line appears on the substitute in non-MICR ink, and (iv) the reconverting bank complies with the other requirements for a substitute check under Check 21.

This would greatly ameliorate a problem that exists under section 9-m of the New York Banking Law² whereby a bank must offer a consumer customer an account where the paid original checks are returned with the customer's statement. A similar problem exists under Massachusetts law.³ Under the Board's proposal, a substitute check that is not encoded in MICR ink would be a "purported" substitute check that is not the legal equivalent of the original check. However, the reconverting bank would still be subject to the warranties and indemnification in §§ 229.52-53 as if it were a substitute check. This would be an unfair result.

Because a check without MICR ink would not be the legal equivalent of the original check, a bank would not satisfy 9-m by returning such a check to a customer with a 9-m account. It would have to MICR-encode the check in order to create a legal equivalent of the original check (provided the other requirements of a legal equivalency are met). We believe this would be operationally inefficient, costly, and unnecessary. We do not believe that a customer would be disadvantaged by receiving a paid substitute check without MICR ink. We do not believe that anyone, without running a substitute check through a reader sorter, could determine whether or not the check is MICR-encoded and that it should therefore be perfectly acceptable as a "proof of payment." Since the check has been paid, it should not be reintroduced into the check collection system and MICR-encoding will not be needed for processing purposes. In summary, we believe that eliminating the printing of MICR information in magnetic ink as a requirement of legal equivalency for a paid substitute check would benefit banks without disadvantaging their customers.

2. *The Board proposes to amend appendix D to require returning bank indorsers to comply with the same indorsement requirements as collecting banks: indorsement on back of check; includes only (1) bank's nine-digit routing number (if the returning bank is a reconverting bank with respect to the check, an asterisk must appear at each end of the number), (2) indorsement date, and (3) an optional trace or sequence number.*

² N.Y. Banking Law §9-m (McKinney 2004)

³ Mass. Gen Laws ch. 167D, § 27

The Board requests comment on what benefits, if any, there would be in providing returning banks with the flexibility to indorse on the front of checks and to include additional information in their indorsements (p 13).

Comment: We do not believe that a returning bank should be given the flexibility to indorse on the front of checks in the proposed regulations. Many image survivable fraud detection features are being implemented by banks that utilize pattern matching software to validate check stock, drawer signatures, courtesy and legal amounts, date, memo line and payee name. The front of the check is critically important to these new features. In addition, other image survivable security features appear on the front of checks such as bar codes, glyphs, holograms, etc. Indorsements on the front of a check might interfere with these features. We recommend that the issue of indorsements on the front of a check should be left for industry standards developed by ASC X9 to address. Placing an indorsement on the front of a check might be feasible if the indorsement were limited to a very restricted area so that the indorsement would not interfere with the security features described above.

3. *Reg CC currently does not require a paying bank to indorse a check. The Board proposes to amend appendix D to require a paying bank that is also a reconverting bank with respect to a substitute check to identify itself as such by placing on the back of the check its nine digit routing number (without arrows) and an asterisk at each end of the number. This identification would not constitute an indorsement. The Board also proposes other technical amendments to appendix D.*

The Board requests comment on all aspects of the proposed indorsement and identification standards discussed above (p 13).

Comment: We have no specific comments on the Board's proposed indorsement and identification standards. We recommend that all indorsement and identification standards related to substitute checks be developed and published by ASC X9 instead of appearing in Appendix D. The commentary to the proposed regulations should state this without identifying the specific standard because standard identifiers may change from time to time (we understand ASC X9 may be changing its current standard identifiers). Indorsement and identification standards are far too technically complex to place in Appendix D. For example, the Board has noted that shifting of indorsements when a check is converted to electronic form and then reconverted in reduced size into a substitute check could result in frequent overlapping and illegible indorsements. In addition, the standards will probably need to be fine tuned as the banking industry gains experience in processing substitute checks. We believe the ASC X9 process would be best situated to identify future changes to the standards.

4. *One of the requirements of a substitute check is that the check must bear a MICR line containing all the information appearing on the MICR line of the original check (except as*

provided under generally applicable industry standards). However, the recipient of a check that fails to meet this requirement has the same warranty and indemnification rights as the recipient of a substitute check.

The Board requests comment on whether a check that fails to meet any of the other substitute check requirements in § 229.2 (zz) also should be treated as though it were a substitute check for the limited purpose of giving the recipient of the check the same warranty and indemnification rights as the recipient of a substitute check (p 15).

Comment: As discussed above, we are opposed to the Board's proposal that a "purported" substitute check would be created if the MICR line on the substitute check does not match the MICR line on the original. The recipient of a purported substitute check would have the same warranty and indemnification rights (under §§ 229.52-53) as the recipient of the original check. We are opposed to the concept of a purported substitute check in general. We do not believe that a check that fails to meet any of the other check requirements in § 229.2(zz) should be treated as a purported substitute check.

5. *One of the warranties made by a bank that transfers, presents, or returns a substitute check for which it receives consideration is that no depositary bank, drawee bank, drawer, or indorser will be asked to make a payment on a check that it has already paid.*

The Board requests comment on whether using information from a check to create an ACH debit entry should be a payment request covered by this warranty (p 16).

Comment: We do not believe that using information from a check to create an ACH debit entry should be a payment request covered by this warranty. As noted by the Board on page 16 of its section-by-section analysis, using information from a check to create an ACH debit entry is a "check conversion" covered by Regulation E not a check transaction covered by the UCC and Regulation CC. The check from which the ACH debit is created is never intended to be introduced into the check-collection process. NACHA rules provide their own warranties to cover a situation in which a check that was converted to an ACH entry does find its way into the check-collection process unless the rules specifically permit the check's reintroduction. See, e.g., NACHA Rule 2.2.1.11 (source document for a POP entry has been voided and returned to the customer); NACHA Rule 2.8.3.7 (the item to which an RCK entry relates will not be presented to the RDFI unless the related RCK entry is returned); NACHA Rule 2.9.3.4 (source document for an ARC entry will be destroyed within 14 days of the settlement date). ODFIs that breach these warranties indemnify any subsequent party for whatever damages result from the breach, including attorneys' fees. See NACHA Rules 2.2.3 (POP entries), 2.8.3.11 (RCK entries), 2.9.3.5 (ARC entries). The NACHA rules thus provide sufficient protection to the parties so that warranties under Regulation CC would be superfluous.

6. *Proposed § 229.54 (b)(3)(p 44) clarifies that a bank that requires a consumer to submit an expedited recredit claim in writing must compute the time period for acting on the claim from the date that the consumer submitted the written claim, even if the consumer previously provided some information relating to the claim in another form. Proposed § 229.54(c) provides that “banking day” (instead of “business day” under Check 21) is to be used to begin measuring the time period for a bank’s action.*

Comment: We agree that a bank’s time period for acting on a consumer’s expedited recredit claim should be computed from the date that the consumer submitted the written claim even if the consumer previously provided information regarding the claim in another form. We also agree that “banking day” should be used to begin measuring the time period for a bank’s action.

7. *Proposed § 229.54(c) (pp 44-43) incorporates each of Check 21’s substantive requirements regarding action on a consumer’s expedited recredit claim but reorganizes those requirements in a way that the Board believes is more straightforward.*

The Board requests comment on whether or not its proposed reorganization of the statutory provisions regarding action on claims is an improvement over the statutory organization and encourages commenter to provide specific organizational suggestions.

Comment: We commend the Board on its proposed reorganization of the statutory provisions regarding action on claims. We believe it is a significant improvement over the statutory organization.

8. *If, after providing a recredit, a bank later determines that the consumer’s claim is not valid, proposed § 229.54(c)(4)(p 45) would allow the bank to reverse both the amount it previously recredited plus any interest that it has paid on that amount.*

Check 21 does not explicitly address the reversal of interest when reversing a recredit. The Board requests comment on whether the approach proposed in § 229.54(c)(4) is appropriate.

Comment: We agree with the approach proposed in § 229.54(c)(4) whereby a bank that determines that a consumer’s claim is not valid would be allowed to reverse both the amount it previously recredited plus interest that it has paid on the recredited amount.

9. *The proposed commentary to § 229.54(c)(p82) clarifies that a bank that receives claims for multiple substitute checks in the same communication must provide the expedited recredit for each such check by the 10th day after submission, unless the bank by that date has determined whether or not the claims are valid. The commentary also clarifies that a bank may, when appropriate, reverse any amount that it previously recredited, regardless of whether such*

amount originally was provided after a determination that a claim was valid or pending the bank's investigation of the claim.

The Board requests comment on whether additional commentary to § 229.54 would be useful and, if so, what specific points should be covered.

Comment: We do not believe that any additional comments to § 229.54 would be useful.

10. Check 21 requires that when a bank provides a substitute check to a consumer in response to the consumer's request for a check, the bank must provide the consumer disclosure (p 50) at the time of request.

The Board believes this could be unnecessarily burdensome to the bank and has proposed two alternative rule provisions regarding when a bank must provide the disclosure to a consumer who requests a copy of a check. Alternative 1 tracks Check 21 and requires a bank to provide the disclosure at the time of the request. Alternative 2 requires a bank to provide the disclosure at the time the bank provides the substitute check to the consumer. The Board requests comment on which of these alternatives is preferable.

Comment: We prefer Alternative 2 with a minor modification. We believe that the Board should modify Alternative 2 to give banks some additional flexibility to consolidate actions. We recommend that a bank be permitted to provide the disclosure at any time up to the time it provides the substitute check to the consumer. This would create operational efficiencies for banks without negatively affecting the consumer disclosure.

11. The proposed amendments to appendix C includes a model consumer disclosure form as model C-5A (pp 52-54).

The Board requests comment on whether the proposed model disclosure is clear, accurate, and concise.

Comment: We believe the proposed model disclosure is clear and accurate. However, it is not concise. We believe the Board should provide a streamlined model disclosure in which a bank could refer to its website or a telephone number for the full-length disclosure.

12. The proposed amendments to appendix C also includes models for the notices a bank must provide in response to a consumer's expedited recredit claim (pp 54-55). No statutory safe harbor applies to the proposed model notices.

In light of the absence of a safe harbor, the Board specifically requests comment on whether providing model languages for the notices is useful.

Comment: We believe the model language for the notice is useful even in the absence of a statutory safe harbor. We believe they will be widely used by banks. We recommend that the regulations contain a statement that in the Board's view a bank's use of the models would constitute compliance with the Act.

13. The Board requests comment on several topics unrelated to Check 21:

- A. Section 229.2 Definitions.*
- B. Section 229.10 Next-day Availability.*
- C. Section 229.13 Exceptions.*
- D. Section 229.15 General Disclosure Requirements.*
- E. Section 229.30 Paying Bank's Responsibility for Return of Checks. Current § 229.30(c)(1) allows for extensions for the deadline of a return or notice of nonpayment under the U.C.C. or Regulation J when a paying bank uses a means of delivery that ordinarily would result in receipt by the receiving bank's next banking day. The proposed amendment would more specifically describe the applicable time of receipt to be the bank's cutoff hour for the next processing cycle (if sent to a returning bank) or next banking day (if sent to a depository bank (pp 39 & 67).*
- F. Section 229.33 Notice of Nonpayment.*
- G. Section 229.37 Variation by Agreement.*

Comment on 13(E): We do not agree with the proposal to more specifically describe the applicable time of receipt to be the bank's cutoff hour for the next processing cycle if sent to a returning bank. This would be very difficult for a paying bank to determine and would lead to uncertainty. We believe the applicable time of receipt for both a returning bank and a depository bank should continue to be the bank's next banking day.

14. Specific Requests for Comment (pp 30 - 31). The Board is also requesting comment on the following issues:

- A. Treatment of Generally Applicable Industry Standards. Should the Board identify specific industry standards within the text of the rules instead of in the commentary?*
- B. Relation of Check 21 to Other Law. Is the proposed commentary adequate with respect to its description of the interaction between Check 21 and existing law?*
- C. Remotely-created Demand Drafts.*

In 2002, NCCUSL approved revisions to UCC Articles 3&4 regarding remotely-created consumer items. The revisions, which have been adopted by one state and introduced in three others, would require a person who transfers a remotely-created consumer item to warrant that the person on whose account this item is drawn authorized the issuance of the item in the amount

for which the item is drawn. The Board requests comment on whether it would be appropriate to incorporate the U.C.C. revisions into Regulation CC.

Comment on 14(A): We believe the approach taken in the proposal to identify specific industry standards within the commentary is the right approach. The industry standard could change from time to time. It would be easier to change a reference to an industry standard if it is identified in the commentary. In addition, the commentary should state that the standards issued by ASC X9 are, at the present time, the only generally applicable industry standards for substitute checks.

Comment on 14(B): With respect to the relation of Check 21 to other law, we believe the proposed commentary adequately describes the interaction between Check 21 and existing law.

Comment on 14(C): The Board has requested comment on whether it would be appropriate to incorporate the 2002 revisions to Articles 3 and 4 of the Uniform Commercial Code regarding remotely created consumer items (p 31). The revisions in question provide that a transferor warrants “with respect to a remotely-created consumer item, [that] the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.”⁴ As transferors are liable to each other in the order in which they take up the draft, the loss would fall on the depository bank or its customer.⁵

Both the Board and the official comment to the revisions to Articles 3 and 4 note that the new warranty represents a limited rejection of the rule of Price v. Neal,⁶ Lord Mansfield’s⁷ famous decision that a drawee is responsible for knowing his drawer’s signature and cannot recoup from the person who presented the draft if it turns out that the drawer’s signature was forged.

This rule was adopted in the original versions of Articles 3 and 4 and represents a basic premise that risk should be allocated to the party who is in the best position to take steps to guard against the risk: because it is the payor bank’s customer’s signature that appears on a check, the

⁴ Amendments to UCC Articles 3 and 4 (Jan. 2003 version), §§ 3-416(a)(6) (indorser’s warranty), 3-417(a)(4) and 4-208(a)(4) (presentment warranty), and 4-207(a)(6) (collecting bank’s warranty). “Remotely-created consumer item” is defined to mean “an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer.” Id. § 3-103(a)(16). The January 2003 version of the amendments to Articles 3 and 4 are available on-line at www.uccpayments.org/docs/January2003-Version.doc.

⁵ See U.C.C. § 3-415(a).

⁶ 97 Eng. Rep. 87 (K.B. 1762).

⁷ William Murray, first earl of Mansfield (1705-1793), chief justice, Court of King’s Bench (1756-1788).

payor bank is in a better position to know that signature and take steps against possible forgeries than any other bank in the collection chain.

This principle does not hold for remotely created items, however. The drawer's signature does not appear on the item, and if the drawer did not in fact authorize the draft and a fraud has occurred, then the drawee bank may not be the party in the best position to take precautions against the fraud. In this case, the principle that the risk of fraud should fall on the party that is in the best position to guard against it results in a rule that the risk should fall on the depository bank or its customer, since it is the depository bank's own customer (or a customer's customer) that created the unauthorized draft in the first place.⁸

This principle holds equally for remotely created items drawn on business accounts as it does on consumer accounts. Because the Board's proposal is limited to items drawn on consumer accounts, it is only a partial solution. The Clearing House is aware of several instances of fraudulent debits sent to business accounts. Indeed, business accounts may be a more inviting target for fraudsters than consumer accounts because the larger balances would make it less likely that an item would be dishonored for insufficient funds and because the greater volume of checks may mean that business customers will take longer to reconcile their accounts and discover forgeries. Recognizing these facts, several states have adopted modifications to Articles 3 and 4 that impose transfer and presentment warranties with respect to remotely created items regardless of whether or not they are drawn on consumer accounts.⁹ The sponsors of the U.C.C. have recognized this fact and have authorized amendments that impose transfer and presentment warranties on all remotely created items, not just remotely created consumer items.¹⁰ For these reasons, we see no point in making a distinction between consumer and business accounts in a rule that imposes transfer and presentment warranties with respect to remotely created items.

A second problem with the rules regarding remotely created items supported by NCCUSL and the ALI is that the transferor warrants only that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. There are, however, other aspects of an item that could be defective. For example the item may carry a fictitious payee, or the accountholder could have authorized the item on the condition that it be deposited for collection at a later date. We believe that the transfer and presentment warranties should cover these aspects of an item in addition to its amount.

⁸ The depository bank would have a claim against its customer for the amount of its loss.

⁹ See e.g., Cal. Com. Code § 3104(k); Colo. Rev. Stat. § 4-3-104(k); Haw. Code Ann. § 490:3-104(k).

¹⁰ See Amendments to UCC Articles 3 and 4 (Feb. 2003 version).

It should be noted that thus far only one state (Minnesota) has adopted the amendments to U.C.C. Articles 3 and 4 as approved by NCCUSL and ALI, while twelve states have adopted amendments that reflect the position taken here.

We therefore support the Board's proposal to require a person who transfers or presents a remotely created item to warrant that the person on whose account the item is drawn authorized the item. However, we believe that the warranty should apply to all accounts, not just consumer accounts, and that the transferor should warrant that the item is authorized according to all of its terms, not just the amount.

Although the Board did not propose any specific language for this warranty claim, we assume that it will be incorporated as an amendment to the warranty provisions of section 229.34.¹¹ This creates an ambiguity because this section is subject to the one-year statute of limitations that apply to subpart C.¹² As the provisions of subpart C normally preempt conflicting state law,¹³ placement of the revised warranty provision in that subpart could lead a reader to suppose that the Board intends to preempt comparable state U.C.C. provisions, which usually provide for a three-year statute of limitations. We believe that the Board should clarify its intentions with respect to this provision and state clearly with the explanations that accompany the publication of the final rule that the new rule is not intended to displace any similar provisions of state law and that the one-year statute of limitations applies to the federal right arising from Regulation CC and that if the applicable state U.C.C. has similar transfer warranties that are subject to the usual three-year statute of limitations, a transferee may initiate a state action within that period.

Finally, we urge the Board to publish proposed language for comment before adopting a final rule.

Additional Change Related to Identity Theft

In addition to the proposed changes to Regulation CC, we suggest the following change, which, we believe, would help reduce the incidents of identity theft. Regulation CC currently requires banks to provide a customer's account number, among other information, when providing the following written notices:

- (i) A notice of a case-by-case delay under Regulation CC § 229.16(c)(2).

¹¹ 12 C.F.R. § 229.34.

¹² Id. § 229.38(g).

¹³ See id. § 229.41.

- (ii) An extended hold notice under Regulation CC § 229.13(g).

Section 229.33(b) and (d) of Regulation CC also currently requires a depository bank that sends notice to its customer of a returned check or notice of nonpayment to include the account number in the notice.

With the mounting increase in identity thefts, we are concerned about using account numbers in our communications to customers. We suggest that in the comments to Regulation CC the Board permit banks to redact all but four digits to comply with these requirements, similar to the account identification requirement in Regulation E § 205.9(a)(4). By permitting banks to so redact, the risk of identity theft and other fraudulent losses may be mitigated.

Problem Related to Check Information that is not Image Survivable

In creating a substitute check, a reconverting bank may encounter checks with security features so that some or all of the information on the original check may not appear on the image thereof by design of such check. We understand that an issuer of money orders, for example, sells money orders with a security feature so that an image of the money order does not contain the amount thereof. We further understand that some colors of ink, such as red, or darkly colored checks do not image well. Imaging a check originally drawn with red ink results in a copy with the handwritten information virtually illegible. An image of a check originally drawn on dark paper results in an illegible copy as well.

If the reconverting bank is unable to generate an accurate image of all of the information on the front and back of a check as of the time the original check was truncated, the reconverting bank may face a claim based on breach of warranty. Because substitute checks will be generated by automated means, that reconverting bank will have no knowledge of this breach until it receives a claim from an indemnitee. We view this result inequitable since the drawer or issuer of the original check caused the poor image of the original check in the first instance. This inequity is underscored when the issuer is a business that reaps profits from the sale of the instrument, such as a seller of monetary instruments. While this result could be mitigated by allocating the loss between the drawer or issuer and the indemnifying banks under the comparative negligence provisions of the Act, we are not confident that comparative negligence is even applicable to these claims. We believe that the better result is to have the party causing the loss, if any, to assume the loss. The illegible substitute check should enjoy legal equivalency notwithstanding the indiscernible image of the check and the indiscernible feature of the substitute check should not be the basis for having liability attach under the Act. This rule of legal equivalency as to such substitute checks would apply solely in those narrow circumstances where the issuer or drawer causes the creation of an illegible substitute check. Perhaps the Board can fashion a rule of preclusion (to be introduced in Regulation CC § 229.56 or its accompanying commentary) as to customer claims similar to U.C.C. § 3-406 (1990 Official Text) in cases where the customer's conduct renders the check not image survivable.

Thank you for the opportunity to comment on the Board's proposed regulations. Due to the complex nature of the proposed regulations and their importance to the nation's payment system, we request an in-person meeting with members of the Board's staff to discuss our comments more fully. The point of contact regarding this matter at The Clearing House is Henry Wysocki. His telephone number is (212) 612-9316.

Very truly yours,

A handwritten signature in dark ink, appearing to read "J. Michael Hunter". The signature is fluid and cursive, with a long horizontal stroke at the bottom.